

December 12, 2005

**AGENDA ITEM 9a**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Domestic Equity Growth Manager RFP
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Staff requests approval to issue a Request for Proposal (RFP) with a "Spring-Fed Pool" feature for domestic equity growth managers. Staff will seek Investment Committee approval for the entire recommended group of managers. Points are allocated between staff and the Investment Committee in the event that the Committee decides to interview and score. Wilshire Associates' opinion letter is shown in Attachment 1.
- IV. ANALYSIS:**

**Executive Summary**

This is an action item seeking approval for staff to conduct an RFP for domestic equity growth managers of both active and enhanced indexing portfolio strategies. Staff requests authority to conduct the search and recommend the selection of managers that best complement CalPERS' existing manager structure. This will provide CalPERS with more flexibility and enhance its ability to improve the relative performance of the external domestic equity program. This initiative was included in the External Equity Management Action Plan for 2005-2006 contained in the Global Equity Annual Plan approved by the Investment Committee at its October 17, 2005 meeting.

The Investment Committee will be asked to vote on the entire recommended group of managers, rather than on individual managers. The RFP will stipulate that the Investment Committee may decide to interview finalists at its discretion. The decision on whether to conduct Investment Committee interviews can be made at the time staff presents its recommendation on the group of managers to include in the pool. CalPERS' current domestic equity growth managers would not need to re-apply.

### Why an RFP is Needed

CalPERS' active external domestic equity program consists of both value and growth equity managers. Of the six active managers in the external domestic equity program, four are value managers and two are growth managers. (The recently hired enhanced indexing managers are style neutral.) Difficult performance in the external domestic equity manager line-up over the past three years has resulted in a number of resignations of growth managers. As a result, the program is in need of additional managers with a growth style.

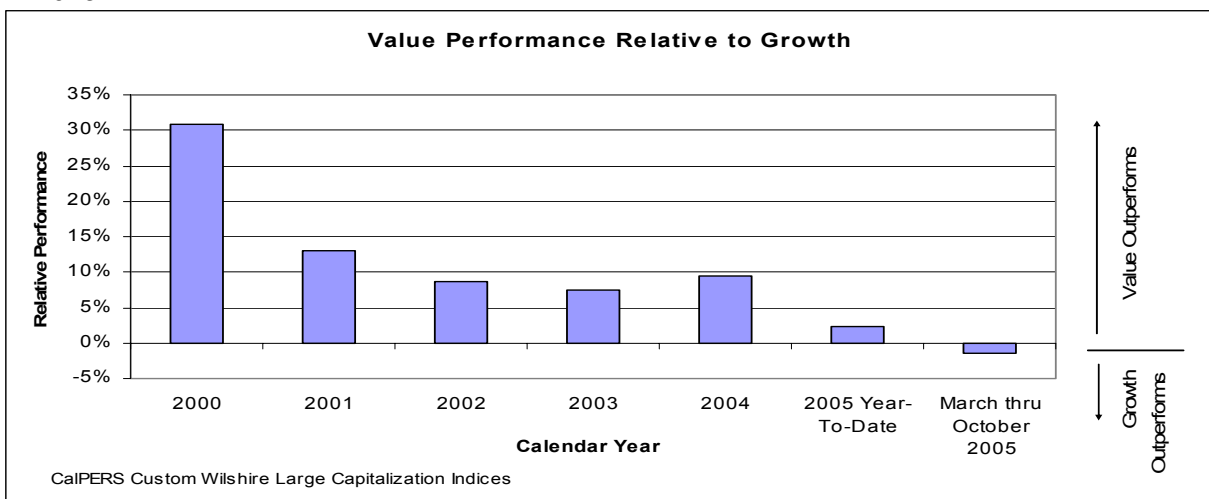
**Table 1**

<b>Style Exposure</b>	<b>Percent of Active External Domestic Equity Program as of 9/30/05</b>	<b>Percent of Active External Domestic Equity Program as of 9/30/02</b>
Core*	62.5%	0.0%
Growth	11.1%	44.1%
Value	26.4%	55.9%

\*Enhanced Index Managers

Value has been doing well over past several years (see Chart 1 below). While it is not the intention of staff to time the growth and value cycle, it is important to have a balanced manager lineup between the growth and value styles, such that when the growth or value style is in favor, we have managers who can outperform in that environment. Typically, growth managers outperform their benchmarks when growth stocks are in favor and value managers outperform their benchmark when value stocks are in favor. Recently, because there have been more resignations in the growth manager lineup, we have had an inadvertent bias to the value style. Staff wants to be sure that the managers that we do have on style benchmarks are balanced between the growth and value styles.

**Chart 1**



Although CalPERS has an internally managed Dynamic Completion Fund (DCF) to mitigate style biases, the DCF is more effective in smoothing out small style imbalances and less effective in smoothing out very large style imbalances. In addition, the DCF's objective is to mitigate risk, not to add active return to the external domestic equity program.

In constructing the external domestic equity manager lineup, staff has attempted to maintain a balanced allocation between growth and value managers. While the DCF, as noted above, will help mitigate style and capitalization biases within the external equity program, it does not minimize the manager specific risk of having too few managers.

Having a limited number of growth equity managers in the external domestic equity program increases the manager specific risk. Manager specific risk results from having too few managers within the manager lineup, thus ending up with a concentration which can significantly impact overall performance and volatility of the external domestic equity program. Due to the limited number of growth equity managers, the impact on the external equity portfolio can be significant if one of the two existing growth equity managers encounters a difficult period of underperformance.

In order to create style neutrality and reduce manager specific risk, staff is requesting approval to issue a Request for Proposal (RFP) with a "Spring-Fed Pool" feature for domestic equity growth managers of both active and enhanced indexing portfolio strategies. In addition, CalPERS staff and many external investment experts (including value managers) anticipate that the growth style will begin to outperform relative to the value style, reversing five years of value outperformance. Therefore, it is important to reduce the growth underweight in the program that was created due to recent manager resignations.

### **Manager Search Process**

In consideration of the Board's policy on Board scoring, staff recommends that 100 points be allocated to the technical proposal, 100 points be allocated to the staff interview, and 50 points be allocated for fees. In the event that the Committee decides to interview and score the bidders, 200 points would be allocated to the Investment Committee interview. Staff will seek input from Wilshire to develop the questionnaire used in the scoring of the bidders' proposals.

It is anticipated that most of the funding for the managers will come primarily from CalPERS' passively managed domestic equity assets. In addition, some funding may be obtained from a reduction in the assets of CalPERS' current external domestic equity managers.

The following criteria will be used for manager selection:

1. Managers with positive active returns against an appropriate growth style benchmark, commensurate with the risk incurred, that have a low correlation to one another.
2. Depth of investment talent and a convincing strategy to retain top talent.
3. A well reasoned investment philosophy and process and the ability to demonstrate why it should add value over the benchmark.
4. A quantitative process for portfolio construction and risk control.
5. Experienced securities traders and evidence of ability to trade in a cost-effective manner for large institutional portfolios.
6. Competitive fee arrangements.
7. A desire to work for CalPERS and deploy adequate and high caliber resources to the relationship.

### **Conclusion and Summary**

- Issuing an RFP for domestic equity growth managers should allow CalPERS to achieve style neutrality in the external domestic equity portfolio.
- Initiating a pool for domestic equity growth managers is desirable to complement and diversify CalPERS' existing external domestic equity manager lineup, reduce manager specific risk, and to help improve performance as styles rotate in and out of favor.
- A Spring-Fed Pool feature is requested in the contracting process in order to facilitate the re-optimization of the portfolio in the future, as well as the inclusion of new managers who may qualify at a later date.
- Staff will seek Investment Committee approval for the entire recommended group of managers. The Investment Committee can decide to interview finalists at the time the recommendation is made.

## **V. STRATEGIC PLAN:**

VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

## **VI. RESULTS/COSTS:**

The allocation to domestic equity growth managers hired under this RFP will come primarily from domestic equity assets that are managed on a passive basis. In

addition, some funding may be obtained from a reduction in the assets of CalPERS' current external domestic equity managers. Current staffing within Global Equity is sufficient to complete this request for proposal.

This item is brought to the Investment Committee in order to enhance risk-adjusted returns and improve the Global Equity opportunity set.

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